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Varieties of Financial Arrangements Possible in Mergers and Acquisitions

by

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This article will address the varieties of financial arrangements possible in mergers and acquisitions as experienced by one Catholic health care system that has finalized four acquisitions and three mergers (two of which resulted in a shared sponsorship) in the past seven years, and been involved in four divestitures. The variety of financial arrangements possible in these transactions is about as diverse as the mergers and acquisitions and the creativity of the sponsors, accountants, and lawyers who put them together.

The number of hospitals and other health care facilities engaged in these transactions continues to mount. The driving force of most mergers and/or acquisitions is usually to secure and enhance future viability given anticipated ongoing changes in the health care environment, and to respond to incentives of health care reform and managed care. For Catholic health care sponsors, the primary objective is to preserve and strengthen Catholic identity and the health care ministry of the Church and thereby to more effectively fulfill the mission of meeting community health needs, especially those of the poor and underserved.

While this article addresses primarily the financial issues, it is important to be equally cognizant of the Catholic, ethical, and moral issues that must be addressed in mergers, acquisitions, and divestitures, so as to safeguard our Catholic values and identity. These issues concern not only the financial but also the human resources we are privileged to steward.

Acquisitions

Each of the four acquisitions was quite different. Two were purchased from for-profit corporations, one from Columbia and one from Tenet. They were both community hospitals that were converted to Catholic facilities and given a Catholic name. The staff in each of these institutions quickly adopted and internalized the Catholic values and continue to exemplify them. In one community a clinic for the poor was built and opened almost immediately and the numbers served rapidly grew.

The third acquisition was a non-profit community hospital and one of two in the city. This hospital was merged into the Catholic hospital with the Catholic sponsor solely responsible for operations. The initial board of the merged entity had three members from the closed hospital, which was later demolished and the land donated to the city in exchange for land that housed a city water tower adjacent to the Catholic hospital. The agreement called for the city to relocate the water tower within one year or pay a very significant penalty to the hospital. It was further agreed that the city would not use the former hospital property for any health care-related facility or services, or anything which would be in conflict with our Catholic values. This acquisition required the discontinuance of certain services and procedures not provided by the religious sponsor. It was possible to transfer these services and procedures to a freestanding surgery center with which the religious-based facility has no relationship or to another hospital in the county.

The fourth was a rather unique transaction in which one Catholic sponsor traded its only acute care hospital for the only three long-term care facilities and an assisted living facility of another Catholic sponsor, leaving each sponsor to do that which they did best, i.e., acute or long-term care. The difference between the financial value of the hospital and the combined long-term care facilities was balanced by a cash contribution. Each of the sponsors agreed to support the other to the extent they could and together they now sponsor a combined home care program.

Each sponsor has one seat on the other's system board, and agreed to support the growth of the other's ministry to the extent possible. Although this transaction was between two Catholic sponsors, it did involve divestiture of Church property and thus had to be Canonically approved by the three bishops in whose diocese the facilities were located and by Rome.

Valuation Methodologies

Arriving at the value of the facility being merged or acquired can often become the greatest negotiating issue. The valuation process is very comprehensive and time consuming. The three methods of valuation that are conventionally applied in establishing the fair market value are the *cost approach*, the *market approach* and the *income approach*, and we used all three of these in one or the other of our transactions.

The cost approach is based upon the assumption that a prospective purchaser would not pay any more for the property than the cost of reproducing a property of similar utility. It considers the value of the land, as determined through market analysis, plus the reproduction cost of the depreciable and certain intangible assets, less depreciation for functional, physical and economic obsolescence. The market approach is based upon the assumption that a prospective purchaser would not pay any more than the market-based cost of acquiring an existing business of similar utility. This is typically ascertained by applying revenue or cash flow based multiples from recent comparable transactions. The income approach is based upon the assumption that a prospective purchaser would not pay more than the risk-adjusted net present value of the expected future cash flows. This approach focuses on the cash flow generating capability of the business, incorporating specific operating and capital assumptions in a prospective analysis. The range of values indicated by the three approaches is evaluated and emphasis placed on the approach that appears to produce the most reliable estimate of value.

Financing

Funding for such transactions can come from operations (should one be so fortunate in these times), investments or long-term debt. For non-profit organizations, tax-free bonds are an attractive means of financing. The challenge here is keeping the organization or system's financial position strong, with a high bond rating so as to make their sale possible.

Mergers

Mergers create additional challenges and opportunities for creative financing, especially if all the sponsors of the merged facilities wish to continue sponsorship. There is usually an expected return on the investment in the form of financial contributions from the operations of the merged entity.

As an example, two sponsoring religious congregations merged two hospitals in the same community into a new corporation with two campuses. The two merged hospitals were two of eight hospitals in the county with fierce competition, as evidenced by seven open-heart surgery programs in the county. The two religious congregations, through their health care corporations, became co-sponsors, co-members and co-owners of the new entity with ownership being at 70% and 30%, based on the value the entities contributed to the merger. Governance is shared with the minority partner holding three seats on a 15-member board. The 70% owner is totally responsible for operations. Each of the sponsors is entitled to an annual grant based upon a predetermined formula and contingent upon meeting agreed-upon financial targets that allow adequate resources for capital as well as operational needs. The intent of these grants was to help support other system facilities which were serving greater numbers of indigent patients. Should there be a need for a capital call, both partners would contribute at the 70/30% level.

Another example would be a merger where one of the facilities is a Catholic sponsored hospital and the second is a non-profit community hospital. They are the only two hospitals in the city. This merger resulted in 50/50% ownership and governance with both parties contributing equally financially. Although the merged entity is a new corporation and has adopted a new corporate name, the two hospitals continue to use their respective Catholic and non-sectarian names and one remains Catholic. The Catholic health system and the non-Catholic parent corporation are the only two members of the merged entity and both members hold the same reserved powers.

The parties agreed that, after the closing of the legal transaction, the Catholic facility would remain Catholic and continue to operate in accordance with the official teachings of the Roman Catholic Church and the *Ethical and Religious Directives for Catholic Health Care Services*. It was further agreed that the other facility would continue to operate in accordance with its non-sectarian identity. The parties agreed that the new corporation would respect and honor human dignity with a special sensitivity to the vulnerable and the poor and would sponsor and provide health care which is patient-centered, compassionate and holistic, focusing on the total individual – body, mind and spirit.

Neither of the hospitals will provide abortions (which neither did previously), tubal ligations, vasectomies, take part in genetic experimentation, or provide assistance to individuals wishing to commit suicide. However, the non-Catholic member of the new corporation would be permitted to provide tubal ligations only at the time of delivery of a child, upon request of the mother, in facilities located on the non-Catholic campus and "carved out" and managed and operated solely by the non-

Catholic member corporation or their designee, and provided further that such designee is not under control of, or affiliated with the new merged corporation. All revenues and expenses as well as billings associated with these procedures are the total responsibility of the non-Catholic member corporation. This member has obtained an ambulatory surgery license from the state for this purpose and completely controls the delivery of these procedures.

Financially, the parties agreed upon the initial fund balance and that one half of that amount would be contributed to the new corporation by each of the members. The corporation would have a budget and sufficient operating funds to function independently in order to accomplish the goals and objectives for the overall benefit of the community served.

As part of a Catholic non-profit health system, the Catholic hospital had been an integral utilizer of all corporate administrative services, and the system was not willing to weaken its position by losing the value of these services. The parties agreed that the new corporation would continue to utilize and the system would be reimbursed for certain of these corporate administrative services, including information services, collection agency services, group purchasing services, master pension trust management and investment fund services, professional liability and medical malpractice coverage and life, health and disability insurance coverage. The other member would receive an amount equal to the cost of administering these services paid to the health system. It was further agreed that the management of the new corporation would from time to time evaluate the fair market prices of these services purchased without competitive bid. If the costs exceeded the fair market price for such services, the new corporation would continue to use these services and the distribution to the other member would be adjusted by an amount equivalent to that portion of the cost of such services in excess of the fair market price.

It was further agreed by the members that banking, cash and investment management services and other insurance, all of which would be equivalent to the value and coverage of those in effect at the time of the merger would be obtained on an annual competitive bid basis.

Needless to say, the complexity of this transaction required a lot of dialogue with the local bishop and ultimately with Rome. The merger documents and corporate bylaws were shared with both the local bishop and the Congregation for Institutes of Consecrated Life and for Societies of Apostolic Life in Rome. A personal visit was made to Rome to discuss the documents with representatives of the Congregation and to answer any questions they had regarding the transaction.

Another kind of merger or affiliation, though one which we have had no experience with, is a joint operating agreement. The distinguishing feature of the joint operating agreement type of affiliation is that the participating hospitals retain their separate identities, boards of directors, and a certain amount of autonomy, even though considerable management and financial authority is shifted to the governing body of the JOA. For example, authority to make moral or ethical decisions based on religious principles is usually retained by the hospitals. These mergers are intended to achieve cost efficiencies by eliminating unnecessary duplications, consolidating managerial decisions, and offering third-party payers unified access to cost effective services.

Divestitures

Another area of related financial arrangements is that of divestitures. When a for-profit facility is sold, the proceeds go to the for-profit corporation and are available for distribution to the shareholders. On the other hand, when a religious congregation divests of a facility the proceeds revert to the health care sponsor, the health care system or the local community for use in continuation of the ministry in the existing or other locations.

We have divested of four facilities during the past ten years. In the first transaction we sold the hospital to a new for-profit company that continued to operate the hospital. Because the hospital was in a very poor area of the city and a second housing project that we had initiated for low-income seniors had just been completed, we continue to co-sponsor and have representation on the board of directors of the housing facilities.

The second facility was sold to Vencor and continues to be operated as a long-term acute care hospital. The local bishop has allowed the hospital chapel to be maintained and to be utilized by the local community.

A third facility was sold to another Catholic sponsor and has been merged into their health care system, and we no longer have any formal relationship to the facility.

The fourth hospital was a very unique transaction in that the hospital was sold twice. The property was sold to a research hospital located across the street and most of the buildings have since been demolished. The land is being used to expand the research facility. The hospital business was sold to another non-Catholic, faith-based hospital and merged into their system. At the time of the sale, an endowment was established to enable the new hospital business owner to continue operating a clinic for the poor in the inner city. Additionally, a significant contribution was made from the proceeds of the sale to build a new housing facility in which to relocate AIDS patients previously located in a home on the hospital property.

In each of these transactions, the employees' welfare was a major concern. Since all of the facilities continued to operate, most of the employees kept their jobs or were offered other positions. The employee pension plans were frozen, and we continue to administer and fund the plans for services prior to the sale.

Although the rapidity of mergers, acquisitions and divestitures taking place throughout the country seems to have slowed down, the challenges facing religious congregations who sponsor health care facilities continues to increase. With the diminishing number of religious available for the ministry, the increasing medical/moral issues we face, and the decreasing reimbursement, we must find ways to continue the development of our dedicated and committed lay leadership and to share sponsorship with them.